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DOW THEORY LETTERS

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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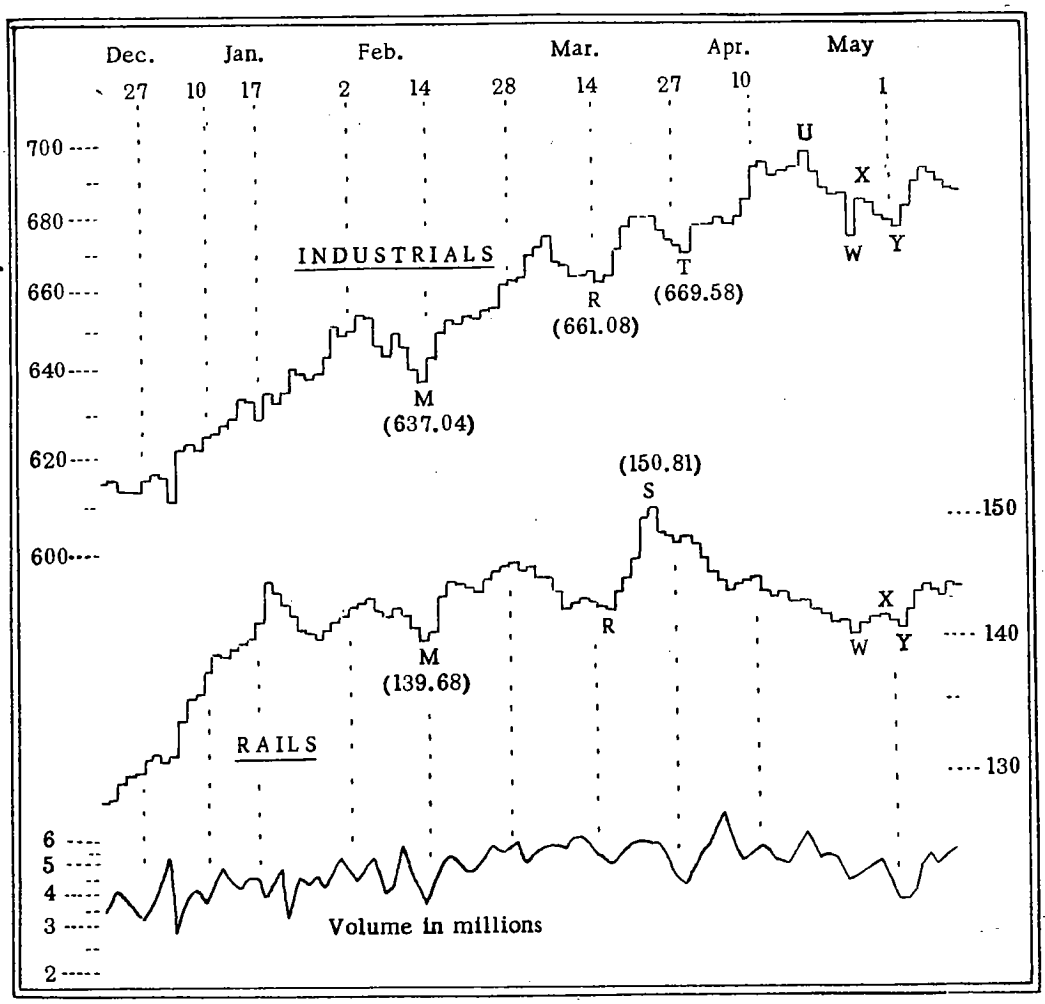
THE MARKET Changes in supply and demand for stocks are reflected by advances or declines in the average price of stocks. Supply and demand for stocks represents the sum total of what everybody knows about anything that can possibly affect the outlook for corporate profits. When the money-majority (as distinct from the numerical majority) believes that forthcoming political, social and economic conditions will be favorable to corporate profits, they buy stocks. Conversely, when the money majority is of the opinion that cash will shortly be more valuable than equity, they distribute stocks, regardless of the optimism which may be reflected in current newspaper headlines.

Over the past few months any number of nerve-jarring headlines have served to "test" the market. So far, Laos, Cuba, Africa, Algeria, Russia's spaceman, President Kennedy's rather nebulous "New Frontier", dismal corporate earnings and warnings from the Stock Exchange's Mr. Funston have failed both individually and collectively to produce more than minor declines in the price structure. Strange as it may seem, however, history shows that the majority of reactions and bear markets have not started with glaring headlines, shouting newsboys and advertisements by investment services to the effect that the market is headed lower. Most professionals will buy a market that holds or climbs in the face of adverse news. Conversely, professionals distrust a market that "sits" or retreats in the face of good news and glowing corporate statements.

If there is a "rainbow" just over the horizon, then the "wise money" that purchased stocks over the past six months will use that rainbow for the purpose of "unloading". This is the reason why veterans become uneasy as the news turns better. They have seen too many markets cave in at about the time that all outward signs suggest that the millenium has arrived.

The primary trend of the market is bullish; we will have a reconfirmation of that fact if Industrials can better their record high of 696.72 (U) set on April 17, and if Rails can better their 1961 peak of 150.81 (S) recorded on March 22.

From the standpoint of trading tactics, the decline which took the two Averages to the W points was a fortunate one. As explained in Letter 142, the Industrial decline to W stopped 3.09 points above the preceding decline level at T, while the Rail decline to W stopped 36¢ above the preceding M level. M (139.68) represents the base of the entire Rail structure which has formed since January, 1961



(see chart). It is a rule born out by experience that the more often a price level is approached or "tested", the more significance that level assumes. For this reason, we can attach considerable importance to the 669-72 level on Industrials and the 139-40 level on Rails.

As long as one or both Averages hold above those levels (Industrials at T -- 669.58, Rails at M -- 139.68), the secondary trend will be taken to remain bullish. Conversely, if both Averages violate those levels (particularly on heavy volume), I would expect no less than a full-fledged secondary reaction. A secondary reaction from this area could be expected to retrace 1/3 to 2/3 of the entire 130 point Industrial advance since October, 1960.

A subscriber asks: "If T and M are broken by Industrials and Rails, how can we be sure that a bear market has not started?" The answer is that we cannot be sure. Under Dow Theory the primary trend is taken to continue until reversed by an authoritative countersignal. The formation which signals a reversal from bull to bear market is as follows: (1) Subsequent to the highs, a full secondary reaction occurs which corrects 1/3 to 2/3 of the preceding primary advance, (2) Both Averages then rally, but one or both Averages fail to better the old highs (3) A second decline takes both Averages below the preceding secondary low points on heavy volume.

Since we have not had a secondary reaction (merely a relatively shallow decline) we cannot accept a possible violation of T and M as a bear signal. However, it is important to remember that a violation of T would entail a penetration of three Industrial decline points -- Y, W and T (see chart). By the same token, a violation of M would entail a penetration of three Rail decline points, Y, W and M. Because of the heightened significance of such a penetration, a closing of the two Averages below T and M would find this writer holding few if any stocks.

Letter 142 identified a typical "buy-spot" at the Y point. On the basis of the buy-spot I wrote that I believed additional speculative purchases were warranted.

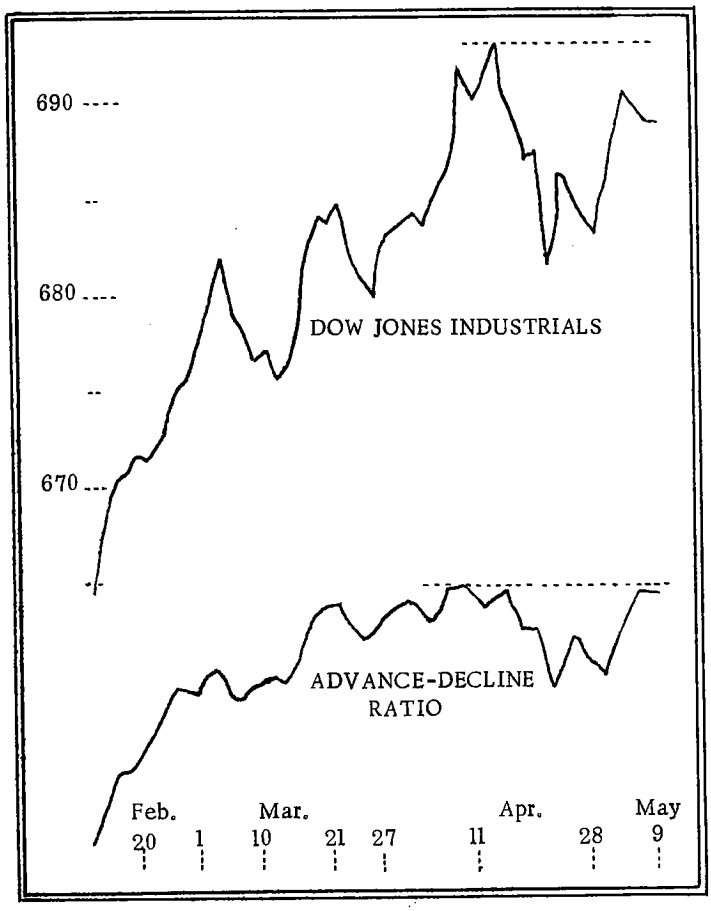
Following Y both Averages climbed sharply higher with Rails forming another minor upward zig-zag. On May 5 and 8 a mild decline set in. On May 9 the two Averages diverged -- Industrials retreating and Rails rising to their highest level since W.

With important decline points so near and the highs (U and S) within striking distance, there is little to be gained by trying to outguess the market. The primary and secondary trends are bullish. Again I will underscore our "insurance policy" -- stocks purchased here should be sold if Industrials and Rails violate T and M respectively.

It is of interest that since early February of this year there have not been four consecutive days in which odd-lot purchases have outnumbered odd-lot sales. Odd-lot short sales hit a low in early April and since then have been slowly climbing. Both of these factors must be taken constructively.

FOLLOW-UP ON BREADTH The chart on page 3 shows the path of the advance-decline ratio (A-D ratio) over the past few months. The A-D ratio takes in the movements of all the stocks on the "Board" and is considered to be representative of the broad market.

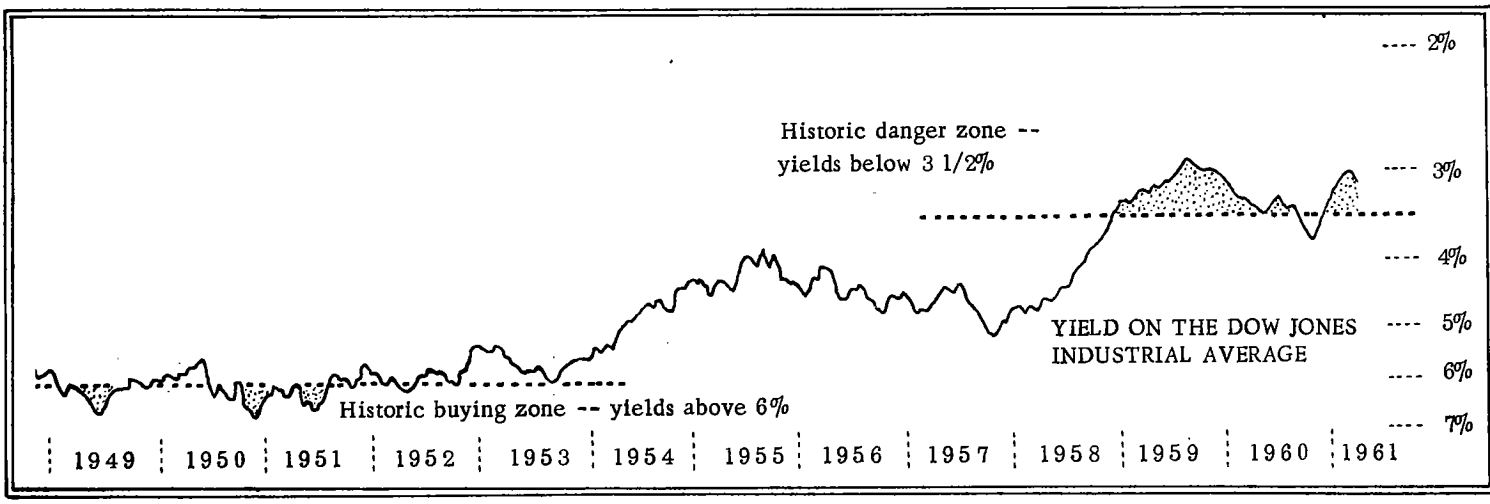
In Letter 140 and 141 the relationship of the Industrial Average and the A-D ratio was



discussed. At that time attention was directed to the fact that the A-D ratio seemed to be "running out of steam". This action proved to be the forerunner of the general decline which set in following the April 17 Industrial peak. Since April 24, however, the A-D ratio (see chart) has performed better than the Industrial Average. As of this writing (May 11) the A-D ratio has rallied to within the merest fraction of its peak level recorded on April 11 and April 17 (see chart). A new high on breadth would have bullish implications for the market, while a decline at this point could spell trouble ahead. The fact that the A-D ratio has outperformed the Industrials since April 24, however, must be taken as a plus for the market.

MORE ON VALUES In Letter 142 I included a word of caution concerning the speculative philosophy which has captured Wall Street and the country. This philosophy is one that invariably takes over during periods of inflated values. At such times purchases can no longer be justified on the basis of yields or return on investment. Obviously, other rationales must take the place of values, and just as obviously these rationales must revolve around possible speculative profits and capital gains.

Personally, I have nothing against speculation as long as one understands what he is doing and refrains from believing that stocks yielding 2 and 3% should "be put away for the kids". History shows that the yield cycle is subject to wide swings. Sooner or later stocks yielding an average of 3% become stocks yielding an average of 6%. If traders can buy stocks here on a 3% yield and sell them somewhere ahead on the basis



of a 2% yield -- all well and good. But is it imperative that subscribers understand that during speculative "booms" the laws of values are temporarily suspended, not displaced.

The accompanying chart shows the average yield on the D-J Industrials from 1949 to the present. On the basis of yields and values, the great buying areas appeared during the years 1949 to 1952. Had one bought stocks in the 6% zone, he would have purchased them with the D-J Industrial Averages in the 160-250 area. Had the same investor been blinded to everything else but values and sold his stocks when the Average yield on the D-J Industrials dropped under 3 1/2%, he would have been selling stocks in the 580-670 area. If he had done just this and nothing more he would have fared better than perhaps 90% of all the stockholders in the country today. Certainly, unless the Industrials now go to 2,000, he would have caught the biggest percentage share of the swing.

The purpose of this study is to provide newer readers with some perspective. But there is another purpose, and that is to provide ammunition for the reader who holds perhaps 80% cash (plus a few speculative commitments to keep up his interest and try his skill).

STOCKS I have shown a chart of International Paper (IP) with weekly high-lows and a 30-week moving average. The stock would appear to have limited downside risk. It held above its December low on the recent decline and is now in a position to rise above its 30-week moving average again (the moving average now stands at 32 1/2). The short interest in IP has been declining but leveled out between March and April. IP may be bought "at the market".

Allis-Chalmers is essentially in its base area with an extreme low (October, 1960) of 22. AH has rallied out of a symmetrical triangle and can be bought here. A move above 28 should send it on its way.

Eastern Airline, having lost half its value during 1959-60, is now poised for a possible major move. The reverse "head-and-shoulders" pattern is clearly visible on the chart and the stock may be bought on dips or on a bettering of 30.

(Written Thursday, May 11th, 1961 - 2 P.M.)